When Having Your Cake And Eating It Too May Be a Bad Thing: Cautions About Cash-Outs Of Unused Leave Or PTO

By Jeff Chang

A number of employers, particularly public agencies, allow their employees to accumulate significant amounts of paid time off, vacation or paid leave (collectively PTO). This article alerts employers to certain practices and policies regarding the cash-out of PTO that could result in large, unexpected tax problems for their employees.

Most employers and their employees assume that the employees will be taxed on wages and PTO only when the employee actually receives the wages or takes the PTO. Unfortunately this is not always the case. The income tax concept of "constructive receipt" treats an employee as having received gross income during a taxable year to the extent that the employee could receive the income during the taxable year if the taxpayer had asked for it. Put another way, a constructive receipt issue is likely to arise whenever an employee is given a choice between receiving cash now or cash or some other benefit in the future. For example, if your PTO policy allows your employees to cash-out up to $10,000 of accumulated PTO each year without restriction, they will have additional income each year equal to the total amount of PTO they could have cashed out – **even if they do not actually cash-out any of their PTO!** If you have maintained a PTO policy of this sort, you should have it reviewed and analyzed immediately. It is quite likely that you have been underreporting your employees' income and under-withholding various income taxes and payroll taxes.

So, how can you allow employees to have their cake (accumulate PTO) and eat it occasionally (cash-out PTO) without creating a big tax problem? There are a couple of recognized approaches:

- Require the employee to make a choice between accruing the PTO or receiving cash in lieu of the PTO **in the year before the year when the PTO will be earned**.

- Allow the employee to cash-out PTO only in the event of a financial emergency where (i) the employee can demonstrate that he has a real financial emergency caused by an event beyond his control, (ii) it would result in serious financial hardship if the cash payment were not made, (iii) the amount of the cash payment is limited to the amount necessary to meet the emergency, and (iv) the employer will determine, at its sole discretion, whether an emergency exists and the extent of the financial need.

Other somewhat more restrictive alternatives would include:

- Allowing the employee to cash-out PTO only upon termination of employment in accordance with the employer's policies regarding PTO;

- Requiring that the value of each employee's unused PTO at the end of the year in excess of a certain carryover amount be automatically paid by the employer to either;

- A profit sharing plan that does not allow distributions until the employee terminates employment with the employer or

- An employee welfare benefit plan, such as a health reimbursement arrangement, that can provide benefits during active employment or after retirement.

The amount to be contributed to the plan is based on a stated conversion rate. The employee has no choice to receive cash in lieu of the contribution.

In the case of employers eligible to sponsor 403(b) or 457(b) plans, it may also be possible to allow employees to make an election, with respect to PTO that will be earned during the following year, to have their employer contribute a specified amount of PTO to their 403(b) or 457(b) account.

One caution: PTO with a cash-out feature may be treated by the IRS as a form of nonqualified deferred compensation that is subject to the requirements and restrictions of Code section 409A. Therefore, it is important to evaluate whether your PTO is exempt from or subject to Code section 409A's rules.

WHAT TO DO

Because no employer can afford to have its employees taxed on the value of PTO they have not actually taken, immediately take a look at your PTO policies and practices to see if they provide for cash-outs. If so, get help to evaluate whether you and your employees already have a constructive receipt issue that needs to be dealt with or whether you can allow them to have their cake by adopting one of the available alternatives.

Please contact Jeff Chang if you'd like more detail on this issue.

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